



NORTH CAROLINA BANKING INSTITUTE

Volume 3 | Issue 1

Article 10

1999

Bankers Beware: The Risks of Syndicated Credits

Megan Elizabeth Jones

Follow this and additional works at: <http://scholarship.law.unc.edu/ncbi>



Part of the [Banking and Finance Law Commons](#)

Recommended Citation

Megan E. Jones, *Bankers Beware: The Risks of Syndicated Credits*, 3 N.C. BANKING INST. 169 (1999).

Available at: <http://scholarship.law.unc.edu/ncbi/vol3/iss1/10>

This Comments is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

Bankers Beware: The Risks of Syndicated Credits

I. INTRODUCTION

Syndicated credits are pieces of large loans, which consist of “credits” of \$50 million or more that the originators of the loans carve up and sell to other parties.¹ For years, everyone from Alan Greenspan² to most recently Julie Williams³ has issued warnings to national banks concerning the impending “troubled waters” or risks associated with syndicated credits, warning banks against sliding lending standards that could harm banks if the economy worsened. Banks have been protected from poor lending practices by a good economy that has buoyed up borrowers. However, these same lending practices could cause banks significant harms in a less euphoric economy that would produce more borrowers that are delinquent. The much touted economic downturn arrived in 1998 in the form of the bailout of the hedge fund Long-Term Capital Management LP,⁴

1. Olaf de Senerpont Domis, *Syndication Risk Getting Worrisome*, Ludwig Warns, AM. BANKER, Dec. 11, 1996, at 2. Burned by the severe industry-wide loan losses suffered by banks in the 1980s, individual banks have been unwilling to take on the tremendously large loans being demanded by the market. *See id.* “Banks, reeling from sizable losses on loans for commercial real estate and credits to less-developed countries, became reluctant to hold more than \$20 million of any given credit in their portfolios.” *Id.*

2. *See Greenspan Advocates Pricing Business Loans According to Risk*, BANKING POL’Y REP. Oct. 17, 1994, at 12, available in LEXIS, Bankng Library, Bnkppl File. For more elaboration of former Chairman Greenspan’s thoughts, see also Jaret Seiberg, *Greenspan Warns Banks on Lending at Thin Spreads*, AM. BANKER, Feb. 25, 1998 at 1.

3. *See Julie Williams, Encouraging Lenders to Stop, Look, Listen: An Address to the RBA/CBA Conference Participants* (Sept. 1, 1998), in 81 J. LENDING AND CREDIT RISK MGMT. 1 (1998) (remarking that the loan “picture is even more disturbing” since commercial underwriting standards have slipped in every category of lending except international loans for the fourth year in a row).

4. *See Banks Clamp Down On Corporate Lending*, L.A. TIMES, Oct. 2, 1998 at D4. The Federal Reserve Bank of New York brokered a \$3.6 billion rescue to prevent the hedge fund from collapsing. *See id.* For more information on hedge funds and their impact on national banks, see *Hearing on Hedge Fund Operations Before the House Comm. On Banking and Fin. Services*, 105th Congress, 1st Sess. (1998) (Testimony of Julie L. Williams, Comptroller of the Currency, as required by 12 U.S.C. § 250). *See also* OCC Advisory Letter 98-45, *Accounting for Derivatives and Hedging Activities*, [Vol. 5 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 71,154 (Oct. 6, 1998) (providing a brief overview of the Financial Accounting Standards Board’s new method for

concerns about world financial stability as the Asian crisis developed, the more pronounced volatility of the stock market, and disappointing earnings forecasts reported by major companies.⁵ Thus, while in 1997, syndicated lending volume broke the \$1 trillion mark for the first time,⁶ the syndicated loan market for 1998 was not as robust. Total syndicated loan volume in 1998 fell 22% to \$872 billion.⁷

In syndicated lending, banks extend loans to corporate clients and then redistribute most of the loan to reduce their own risk.⁸ As the economic situation causes investors to act more cautiously, and investors look more closely at the terms of the deal, the era of easy dispersion of syndicated loans could be over.⁹ The economic situation, combined with risks concomitant to erosion of lending standards, has led to a decline in demand, indicating that perhaps the syndicated loan market is coming under greater scrutiny.¹⁰

However, while a slumping economy may depress the market for some economic activities, this economic environment could send corporate clients in search of loans, providing a boon for banks.¹¹

accounting that goes into effect on January 1, 2000 for derivatives and hedging activities (SFAS 133)).

5. See *Banks Clamp Down on Corporate Lending*, *supra* note 4, at D4. The world economy has declined since July 1998. See *id.* For instance, Russia devalued its currency and defaulted on debt and Thailand, South Korea, and Indonesia are in recession. See *id.* See also Zach Schiller, *Banks Tightening Up Credit*, *Fed Say*, PLAIN DEALER, Oct. 6, 1998, available in 1998 WL 4157692.

6. See Omri Ben-Amos, *Syndications Ended '97 at \$1 Trillion—And Rising*, AM. BANKER, Jan. 12, 1998, at 7.

7. See Paul Beckett, *Syndication of Loans Sees Big Changes*, WALL ST. J., Jan 27, 1999, at C1 (relying on the research firm Loan Pricing Corporation). Securities Data Company reported, however, that syndicated loan volume totaled \$1.012 trillion in 1998, still down from the record \$1.102 trillion in 1997. See David Weidner, *Syndicated Lending Boom Hits a Seventh-Year Glitch*, AM. BANKER, Jan. 11, 1999, at 1. Regardless of the exact figure, the decline in volume in 1999 was the first since the credit crisis of 1991. See *id.*

8. See Domis, *supra* note 1, at 2.

9. See Anita Raghavan, *Syndicate Loans Get Difficult for Wall Street*, WALL ST. J., June 24, 1998, at C1.

10. See *id.* Recently, Morgan Stanley was forced to postpone the syndication of the loan after Sunbeam's chief executive was removed and its weakened financial condition was revealed. See *id.* Also, Salomon Smith Barney, a relative newcomer to the syndicated credit market, was unable to attract enough buyers to syndicate Meditrust Corporation's \$2.25 billion loan and was eventually replaced by J.P. Morgan and Company. See *id.*

11. See Matt Murray & Paul Beckett, *Syndicated Lending is Seen Falling in '98*, WALL ST. J., Oct. 15, 1998, at C1 (noting the current major opportunities for the major arrangers of syndicated debt).

Arrangers of syndicated debt could profit from this economic turn of events.¹² Banks that want to thrive in the crowded¹³ syndicated loan market should structure their deals to safeguard against risks that may not be present at the time of the deal.¹⁴ By employing wise credit standards, banks can both protect against costly risk and at the same time attract customers. This Note first will define what a syndicated credit is,¹⁵ illustrate a sample transaction,¹⁶ and list reasons for its use.¹⁷ It will then examine several risks that banks become exposed to when syndicated credits are used.¹⁸

12. *See id.* The top five syndicated loan managers in the first nine months of 1998 were: Chase Manhattan (\$179.8 billion in proceeds and 23.9% of market share); Bank of America (\$122.4 billion in proceeds and 16.2% of market share); J.P. Morgan (\$94.4 billion in proceeds and 12.5% of market share); Citicorp (\$66.5 billion in proceeds and 8.8% of market share); and Bankers Trust (37.7 billion in proceeds and 5.0% in market share). *See id.*

13. More banks want to enter the syndicated credit market, and are competing with established leaders for the same number of deals. For more explanation, see *Too Much Money is Chasing Business*, LLOYD'S LIST INT'L, Oct. 28, 1997, at 12 (analyzing competition among banks for syndicated loans in the shipping industry).

14. *See Banks Clamp Down on Corporate Lending*, *supra* note 4, at D1. In a survey conducted by the Federal Reserve Board, almost 30% of large banks (with assets of 15 billion or more) have reported tightening standards. *See id.* About 10% of the smaller banks had done so. *See id.* When banks tighten lending standards, it does not necessarily mean they charge higher rates. *See Banks Tightening Up Credit, Fed Say*, *supra* note 5, at D4. They may require more collateral, shorten the length of the loan, or require a loan recipient to personally guaranty more of the loan to his or her company. *See id.*

15. *See infra* notes 19-34 and accompanying text. Although there are many types of credit agreements, this Note will address only credit agreements used for general business dealings in which one or more lending institutions agree to lend to U.S. domestic corporate borrowers. For information on foreign corporate borrowers, see Suzanne Harrison, *The Extraterritoriality of the Bankruptcy Code: Will the Borders Contain the Code?*, 12 BANKR. DEV. J. 809 (1996); Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership,"* 16 ANN. REV. BANKING L. 227 (1997); Alfredo G. Romero, *The Letter of Intent in International Syndicated Financing: An Analysis of the English and American Law from a Sovereign Borrowers' Perspective*, 3 NAFTA: L. & BUS. REV. AM. 74 (1997).

16. *See infra* notes 35-65 and accompanying text.

17. *See infra* notes 66-93 and accompanying text.

18. *See infra* notes 94-239 and accompanying text.

II. BACKGROUND

A. *Syndicated Credit Defined*

Multiple lender transactions¹⁹ generally fall into two categories: loan participations²⁰ and loan syndications.²¹ The first category, loan participations, involves transactions where a lead (or originating) lender sells a part of or all of a loan to one or more purchasers.²² Participation, thus, can be defined as a third party's acquisition of a specified percentage of a prearranged loan.²³ The relationship between the parties is typically formalized by a participation agreement, which is an agreement in writing stating that the purchaser receives an undivided interest in the loan.²⁴ The sale occurs after the lead lender has made the loan to the borrower.²⁵ Because all documentation and terms concerning the loan are agreed upon and completed before the sale to any third party, the purchaser is dependent upon the lead for protection of its interests in the loan.²⁶ Participations are usually used in secured loan transactions and the value of the collateral of the underlying loans determines the credit

19. For treatment of issues surrounding multi-lender transactions not addressed by this article, see W. Crews Lott et al., *Multiple Lender Transactions: Current Issues*, 112 BANKING L.J. 846 (1995) (including Uniform Commercial Code considerations, the inclusion of exculpatory clauses, and discussion of relevant case law).

20. A participation is the "acquisition by a third party from the lender of an interest in a loan; a participant entering into an established loan generally takes all of the agreements between the lender and the borrower 'as is'" Stuart Hirshfield, *Joint Loans and Participations*, in ASSET BASED FINANCING: A TRANSACTIONAL GUIDE § 10.02[1] (Howard Ruda ed., Matthew Bender 1994). See also OCC Advisory Letter 97-21, *Guidance on Sales of 100% Loan Participations*, [Vol. 6 Transfer Binder] Fed. Banking L. Rep. (CCH) 73,115-16 (April 10, 1997) (providing guidance for short term loans originated by an institution that sells off, without recourse, 100% of the participation under a continuing program, and retains no interest in the originated loan).

21. A syndicated credit is a joint loan wherein "each lender is in direct privity of contract with the borrower and has rights and may have claims which are assertable directly against the borrower; . . . [and] each lender makes its own loan to the borrower under the general terms of the joint loan agreement." Hirshfield, *supra* note 20, § 10.03.

22. See *id.* § 10.02[2]. For an explication of recent cases impacting loan participations, see also W. Crews Lott et al., *Structuring Multiple Lender Transactions*, 112 BANKING L.J. 734 (1995) [hereinafter Lott et al., *Structuring*].

23. See Hirshfield, *supra* note 20, § 10.02[1].

24. See *id.*

25. See *id.*

26. See *id.*

rating.²⁷ The collateral protects the acquiring lender from any infirmity in the terms arranged by the lead lender. Despite the involvement of third party lenders, the borrower's contractual relationship often remains strictly with the lead lender.²⁸ Thus, the borrower may remain totally unaware that a participant in the loan exists.²⁹

The second type of multi-lender transaction, loan syndications, involve two or more lenders who make a loan(s) to a borrower under a common loan agreement.³⁰ Each lender is a syndicate member.³¹ Unlike participations, the borrower has direct relationships with each of the lenders.³² Thus, each syndicate member is in direct privity of contract with the borrower.³³ Each syndicate member can rely on typical lending practices when documenting the terms of the agreement between themselves and the borrower since syndicated credit transactions are similarly documented as any single lender loan.³⁴

B. *Sample Transaction*

In a syndicated credit, one of the lenders will be designated as the agent-bank (agent) for the other syndicate members and the borrower.³⁵ The agent is typically the lender owning the largest percentage of the loan or the lender with enough industrial clout to form a syndicate of lenders.³⁶ The agent may also be the lender with an established relationship with the borrower.³⁷ The agent is responsible for structuring the intended credit facility, pricing the loan, developing information pertaining to the borrower (and providing that information to other co-lenders in the syndicate) and

27. *See id.* § 10.01[1]. The collateral protects the acquiring lender from financial losses not protected or accounted for in the participation agreement. *See id.* Thus, not being involved in the negotiation of the participation agreement typically does not put the acquiring lender at risk. *See id.*

28. *See id.*

29. *See id.* *See supra* note 20 and accompanying text.

30. *See* Hirshfield, *supra* note 20, § 10.01[1].

31. *See id.* § 10.03[2].

32. *See id.*

33. *See id.*

34. *See id.* § 10.03[1]. *See generally* PETER S. CLARKE, COMPLETE GUIDE TO LOAN DOCUMENTATION (1986) (describing typical loan documentation practices).

35. *See* Hirshfield, *supra* note 20, § 10.03[3].

36. *See id.*

37. *See id.*

negotiating and closing the transaction.³⁸ Thus, all formal communications between the lenders, as a group, and the borrower are conducted through the agent and all funds are disbursed through and received by the agent.³⁹

The agent will begin a syndicated credit like any other loan between a borrower and a lender.⁴⁰ The agent may draw other lenders from its own established contacts or it may have to work with a network of lenders already chosen by the borrower.⁴¹ The agent prepares a term sheet⁴² (summarizing key aspects of the loan)⁴³ to circulate to the syndicate members.⁴⁴ Each syndicate member may address comments on the terms and provisions to the agent.⁴⁵ Once the members are in agreement and the borrower agrees to the general terms of the loan, the agent will begin⁴⁶ drafting the document.⁴⁷

38. *See id.* Negotiation of a lending agreement "is in essence a team or cooperative effort." SIDNEY S. GOLDSTEIN, *BANK LOAN AGREEMENTS* 1 (1990). It requires the "expertise of counsel, senior management and the corporation's accountants." *Id.* Although necessarily the counsel must become familiar with the corporation's business, "counsel should not be placed in the untenable position of acting as a financial analyst and managerial expert." *Id.* Further, to make sure that the borrower's undertaking in the credit agreement is not unsuitable or impossible to fulfill, the borrower and its accountants should also be involved at some point in the negotiating and drafting stage of the credit agreement. *See id.* *See generally* SANDRA SCHNITZER STERN, *STRUCTURING COMMERCIAL LOAN AGREEMENTS* § 10.06[1] (2d ed. 1990) (describing how a syndicated credit differs substantially from a single bank loan agreement).

39. For background information on common issues regarding the formation of a syndicate, see GOLDSTEIN, *supra* note 38, at 335. For more information on the structuring phase of multilender relationships, see Lott et al., *Structuring*, *supra* note 22, at 736.

40. *See* Hirshfield, *supra* note 20, § 10.03[3][b].

41. *See id.*

42. *See* Venrice R. Palmer, *Negotiating and Drafting Bank Credit Agreements*, in *DOING DEALS 1997: UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE*, 831, 837 (PLI Corp. Law & Practice Course Handbook Series No. B4-7168, 1997). A term sheet is a summary of the basic terms of the tentatively agreed-upon transaction. *See id.* It is not intended to be binding. *See id.* This summary will be sent to the proposed syndicate banks along with an invitation to participate in the loan. *See id.* (citing C. Edward Dobbs and Bobbi Acord Gomez, *Commitment Letters: Uses and Pitfalls*, 76 THE J. OF COM. LENDING 11 (1993)).

43. This may be substitute for or in conjunction with a proposal letter (generally a non-binding indication of interest in a loan by a lender to a potential borrower.) *See* Palmer, *supra* note 43, at 837. *See also* Marsha E. Simms, *Structuring and Closing of Commercial Loans*, in *BANKING AND COMMERCIAL LENDING LAW*, at 163 (ALI-ABA Course of Study, 1997).

44. *See* Simms, *supra* note 43, at 165.

45. *See id.* The adequacy of the terms will depend on the syndicate member's individual assessment of the borrower. *See id.*

46. The American Bar Association recommends that commercial lenders address the following issues prior to documentation: lender's control over borrower's cash, timing of

Since all lenders are parties to all agreements, each lender must make its own loan to the borrower under the general terms of the syndicated credit agreement.⁴⁸ Accordingly, each lender will receive a promissory note made by the borrower for the percentage of the loan made by that particular lender, which also bears interest at the rate specifically agreed to with that lender.⁴⁹ Beyond the general terms, each specific syndicate member is at liberty to enact more terms or covenants with the borrower.⁵⁰ Each syndicate member typically employs special counsel⁵¹ to draft the promissory note, any security agreements it particularly desires, and to supervise the legal aspects of the loan.⁵²

In addition to the general terms of the loan, the syndicate members must agree to certain special provisions.⁵³ They will determine among themselves the necessary percentage of lenders required to approve aspects relating to the borrower or to the loan itself.⁵⁴ For example, a majority vote of the syndicate members may be necessary to consent to acquisitions, a sale of assets, or a declaration of dividends by the borrower.⁵⁵ A similar provision may be

required financial reporting, schedules for necessary environmental reporting, deadlines for real estate surveys or appraisals, landlord waiver issues, interest rate protection if it is a floating rate loan, and necessity of solvency letters. *See id.*

47. *See id.* (noting five protective provisions that the agent should include for itself).

48. *See id.*

49. *See id.* The interest rate may be based on: the lender's own prime rate, the prime rate of the lead lender, the average rate of a group of lenders, or a rate based upon an agreed index. *See id.*

50. *See id.*

51. An important role lawyers play in lending transactions is in "helping to structure a loan that provides protection to the lender and at the same time allows the lender's customer to conduct its business in the normal course." *Id.* Too much protection for the lender can actually jeopardize the borrower's ability to conduct business and thus jeopardize the very means of repayment. *See id.*

52. *See id.* One legal aspect of the loan attorneys consider is lender liability. For general treatment of lender liability, see Robert F. Finke & Janet L. Reed, *Experts in Lender Liability Lawsuits: Their Use and Misuse - A Practical Guide in Outline Form*, in *BANKING AND COMMERCIAL LENDING LAW*, at 183 (ALI-ABA Course of Study, 1989); Richard J. Goldstein, *Loan Structures and Third Party Problems*, in *ASSET BASED LENDING* at 333 (PLI Corp. Law & Practice Course Handbook Series No. A4-4250, 1989); John Francis Hilton, *Drafting Loan Documents in Order to Avoid Lender Liability Claims*, in *LENDER LIABILITY LITIGATION 1989: RECENT DEVELOPMENTS*, at 871 (PLI Corp. Law & Practice Course Handbook Series No. A4-4277, 1989).

53. *See* Hirshfield, *supra* note 20, § 10.03[3][c].

54. *See id.*

55. *See id.*

required to waive the borrower's failure to maintain an agreed upon amount of net worth or other similar covenant.⁵⁶ To approve an act of the borrower, a majority *in amount*⁵⁷ of the outstanding principal amount of the loan or alternatively, a majority *in number*⁵⁸ of the holders of the borrower's notes may be required.⁵⁹

After the original syndication has been made, syndicate members can find buyers for the original syndicated loan in a small secondary market.⁶⁰ Though trading volume has tripled since 1994, the secondary trading of syndicated loans represented a minuscule percentage of the \$1 trillion worth of syndicated loans originated in 1997.⁶¹ Further, the growth potential is enormous, since only a small fraction of non-bank investors have "discovered" loans as an asset class.⁶² This secondary trading growth potential is evidenced by the announcement of the Loan Syndication Trading Association to compile an index that would measure the value of the leveraged loans in the secondary market, scheduled to be unveiled in late 1999.⁶³ This index may help the secondary loan market grow as large as the markets for collateralized mortgage obligations and asset-backed securities.⁶⁴ Similar to the emerging syndicated loan market, those markets did not exist twenty years ago.⁶⁵ Thus, secondary trading may become a more common aspect of a syndicated loan transaction.

56. *See id.*

57. *See id.* This provision would allow those who own a larger percentage of a loan have more control. *See id.* For example, if it was a \$100 million syndicated credit, only enough votes of lenders equaling \$50 million would be needed to approve an action. *See id.*

58. *See id.* This provision would allow each lender have the same decision making power. *See id.* For example, if it was a \$100 million syndicated credit, 50% of all the lenders (regardless of the percentage held) would be needed. *See id.*

59. *See id.*

60. *See* David Weidner, *Wall Street Taking Steps to Speed Growth of Secondary Loan Market*, AM. BANKER, Dec. 9, 1998, at 1. Some banks see the loans traded in the secondary market as undesirable, as the place where foreign investors and the investment banks get rid of loans they no longer want to hold. *See id.*

61. *See id.* (relying on Loan Pricing Corporation of New York, it represented about \$50 billion out of the \$1 trillion syndicated credit loan pool). The secondary market for syndicated loans is growing, however. *See id.*

62. *See id.*

63. *See id.* The association is also redesigning its mark-to-market program, which provides portfolio managers with the latest bids and offers on 750 secondary market loans as reported by association members (scheduled to be finished to by spring 1999). *See id.*

64. *See id.*

65. *See id.*

C. *Reasons For Its Use*

A lender may choose a syndicated credit agreement for several reasons. First, banking regulations restrict the amount of loans banks may make to any one borrower.⁶⁶ A bank can lend an additional 10% of its capital when the additional loans are fully secured by marketable collateral.⁶⁷ Thus, a bank may not be able to provide a large enough loan for one of its customers if such loan exceeded 25% of the bank's capital. Second, agents may augment their income⁶⁸ through fee income.⁶⁹ Third, banks may wish to diversify their portfolios.⁷⁰ This is especially true of regional banks whose portfolios reflect the businesses and industries in their area, exposing a bank to the detrimental reliance on one business climate.⁷¹ Fourth, capital banks must hold a certain amount against their assets, otherwise known as regulatory capital⁷² restrictions, which may preclude a bank from adding a large loan or commitment to its balance sheet.⁷³ With

66. Thus, national banks typically may not lend more than 15% of their capital to any one borrower. See 12 U.S.C. § 84(a)(1) (1994). See also Lott et al., *Structuring*, *supra* note 22, at 734.

67. See 12 U.S.C. § 84(a)(2) (1994).

68. Three large regional banks reported second quarter earnings in 1998 ahead of Wall Street expectations due to growth in fee income. See *id.* Further, at Chase Manhattan, fees from syndicated lending, investment grade bond underwriting and other investment banking activities rose 55% from last year to \$438 million. See Matt Murray & Joseph B. Cahill, *Chase, Citicorp Profits Top Estimates; Fee Income Lifts Net at Regional Banks*, WALL ST. J., July 22, 1998, at A4.

69. Fees are imposed for a variety of purposes: a flat fee added to increase the yield of the loan, a fee designed to cover the costs incurred with syndicating the loan (for structuring and negotiating the loan package, underwriting the loan, and advising the borrower), or a fee for serving as agent in the administration of the syndicated credit. See *Foreign Lending*, 2 O.C.C. Q.J. 50 (1983), available in 1983 WL 175064.

70. See *id.*

71. See Palmer, *supra* note 42, at 837. See also Alan Sanborn, *New Risk Management Tools Help Credit Quality*, AM. BANKER, Oct. 15, 1997, at 4 (noting that statutory restrictions on geographic distribution have lessened considerably, allowing greater diversification and less concentration).

72. See Donald J. Tuomey, *Bank Regulation, Bank Accounting, and Bank Failures*, in 1991 ANNUAL SURVEY OF AMERICAN LAW 823, 825 ("The capital of a banking organization is a very simple concept. Capital is what is left over after one subtracts the total of the banking organization's liabilities from the total of its assets.").

73. For treatment of the FDIC's role, see Thomas M. L. Metzger, *FDIC Capital Directive Procedures: The Unacceptable Risk of Bias*, 110 BANKING L.J. 237 (1993) (discussing the FDIC's ability to issue a capital directive, an order to a bank to raise its capital holdings, and the inadequacy of providing only one opportunity for banks to challenge this).

syndication, the amount of capital a bank is required to maintain against the particular loan is less than if the bank was the sole lender for the entire amount. The bank must retain only a portion of the loan (and thus is required to only have reserves for that portion) as opposed to the entire balance of the loan.⁷⁴

Further, syndicated credits allow greater autonomy for each syndicate member when compared to a loan participation.⁷⁵ If taken advantage of, banks can actively protect their own financial interests in the loan rather than being forced to rely on the lead lender to steer the transaction.⁷⁶ For example, each syndicate member is given an equal opportunity to obtain directly from the borrower information which helps banks ascertain if the borrower is an acceptable risk based on the bank's own criteria.⁷⁷ Each syndicate member also has direct control over the terms and provision in the loan agreement beyond the general terms.⁷⁸ Likewise, all members have control over waivers, consents and acceleration, and they have agreed to the required percentage of lenders necessary to act.⁷⁹ Thus, banks receive greater control over their investments. They have the means to choose and shape investments that coincide with the amount of risk that they are willing to undertake.

Another reason banks choose syndication is because each member is in the advantageous position of being able to protect its investment by participating in the enforcement of the loan in case of a delinquent borrower.⁸⁰ If the loan is secured, each syndicate member has a direct interest in the collateral as security for its proportionate loan, despite the fact that another lender designated as agent perfects the security interest.⁸¹ Thus, each member is able to enforce remedies relating to its security interests and to direct the agent's acts upon the

74. More than ever, Congress and federal agencies are focusing on the importance of a bank's capital as a measure of its health. See Tuomey, *supra* note 72, at 825.

75. See Hirshfield, *supra* note 20, § 10.03[4][a].

76. See *id.*

77. See *id.*

78. See *id.* Despite the fact that an agent might draft the agreement, each syndicate member has a voice in determining its provisions. See *id.*

79. See *id.*

80. See *id.* Each member has individual contractual privity with the borrower, enabling each member to begin enforcement action if necessary. See *id.*

81. See *id.*

event of the borrower's default.⁸² Members can even go so far as to demand maintenance of individual deposit accounts, or payments of additional monies for the borrower's failure to maintain covenants.⁸³

A borrower may enter a credit agreement for a variety of different reasons. It may need an immediate loan for acquisition of assets, debt refinancing, or inventory financing.⁸⁴ Alternatively, the borrower may want the security of a committed facility from which it can borrow on relatively short notice, since the terms and conditions have been negotiated "up front."⁸⁵ This is known as a revolving line of credit⁸⁶ and "frequently include a subfacility for the issuance of letters of credit to fund the working capital needs of the borrower."⁸⁷

The borrower may also enjoy several benefits from being in a direct relationship with several lenders. Also, if one lender is played against another, the competition among the banks to obtain the loan may result in the borrower obtaining more flexible loan terms and a more favorable interest rate on the entire loan.⁸⁸ Additionally, if the borrower wishes to expand nationally or regionally, a syndicated loan obtained from lenders throughout the targeted expansion region results in an advantage for the borrower.⁸⁹ Once the loan is established, local

82. *See id.*

83. *See id.* Banks want to know the borrower's ongoing operating results during the term of the loan and will want certain restrictions on the borrower's business. *See id.* These restrictions are known as covenants. *See Palmer, supra* note 42, at 869-85.

84. *See id.* Certain short-term obligations may be classified as long-term debt where the debtor has the ability to refinance the short-term obligations with long-term debt. *See id.* (citing D. EDWARD MARTIN, ATTORNEY'S HANDBOOK OF ACCOUNTING, AUDITING, AND FINANCIAL REPORTING (1994)). If certain conditions are met, a credit agreement with a term greater than a year could be used for this purpose. *See id.*; *see also* David J. Lamb, *Issues in Long-Term Debt Classification*, 65 CPA J. 44 (1995).

85. *Palmer, supra* note 42, at 833.

86. *See id.* at 835. Often called a "revolver," this obligates a bank to lend up to a stated amount. *Id.* The borrower may prepay and reborrow throughout the term of the agreement. *See id.* Typically, the borrower only pays interest on outstanding principal and repays the principal upon expiration of the agreement. *See id.*

87. *See id.* *See also* OCC Interpretative Letter No. 412, *Legal Lending Limits: General Obligation of States and Political Subdivisions* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,636 (Jan. 26, 1988) (describing the impact of standby letters of credit on a bank's legal lending limits).

88. *See Hirshfield, supra* note 20, § 10.03[4][b]. For example, New England Electrical Systems recently replaced bilateral lines of credit with its first syndicated credit because the company was able to secure better pricing (LIBOR plus .25%). *See Borrowing Strategies: New England Electric Opens First Syndicated Credit*, BANK LETTER, Dec. 15, 1997, available in 1997 WL 12156694.

89. *See Hirshfield, supra* note 20, § 10.03[4][b].

credit references or other information concerning the borrower can be obtained from a lender in that region.⁹⁰ Further, the lenders, for hardly altruistic reasons, may introduce new business contacts to the borrower in order to assist the expansion of the business.⁹¹ Lastly, borrowers with widespread offices and plants may be pleased with the ability of syndicate member banks to provide payroll check cashing or other customer service perks to employees by members in those areas.⁹² Suddenly, the borrower is provided with a larger network of financial resources by utilizing syndicate members located throughout the country.⁹³

III. RISKS OF SYNDICATED CREDITS

A. *Institutional Investment*

The number, size, and complexity of syndicated credit transactions have grown dramatically as lenders have shifted their focus from investment growth to both maximum return on assets and more cautious risk diversification.⁹⁴ Consequently, syndicated credit agreements are no longer strictly composed of traditional bank to bank relationships.⁹⁵ Today, multi-lender credits increasingly are composed of nontraditional lenders such as mutual funds, trust departments, corporate treasuries, and other institutional investors.⁹⁶ This increased institutional investment in syndicated credits has brought about two risks to banks: that institutional investors will crowd out commercial

90. *See id.*

91. *See id.*

92. *See id.*

93. *See id.*

94. *See* OCC Advisory Letter 97-3, *Credit Underwriting Standards and Portfolio Credit Risk Management*, [Vol. 6 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 73,271, at 73,274 (Mar. 11, 1997). Banks are now focusing on managing exposure and on return rather than on credit issues. *See id.* This trend is caused by the reality of today's market: there is more demand for high-yield commercial paper (short-term unsecured promissory notes of a prime corporation) than there is a supply of investment-quality transactions. *See id.* *See also* TIMOTHY W. KOCH, *BANK MANAGEMENT* 98 (3d ed. 1995).

95. *See* Mahua Dutta, *Institutional Investors' Rush to Bank Loans Poses a Puzzle for Banks*, AM. BANKER, July 23, 1997, at 12.

96. *See id.*

banks and that institutional syndicate members will compete to supply the financial services required by the borrower.

1. Crowd out commercial banks

The first risk that commercial banks are exposed to when they use syndicated credits is the threat to the management of the loan syndicate due to the increased participation of institutional investors.⁹⁷ The influx of institutional investors can make syndicated credits so risky that commercial banks will not become a part of the deal. This first effect is due to the two different approaches to investments embraced by commercial banks versus institutional investors. Institutional investors take more of a “bond mind-set”⁹⁸ (or trading mentality) rather than a more cautious “secured mind-set” in their approach to the loan.⁹⁹ Commercial banks, characterized by the senior secured mind-set, typically are attracted to the stability of the loan market.¹⁰⁰ A loan’s value is tied to interest rates. This makes them less volatile.¹⁰¹ Since banks value their loans at face value, there is not much incentive to trade them.¹⁰² The hallmark of this mind-set is the buy-and-hold strategy, a risk adverse strategy that does not require active maintenance of the investment.¹⁰³ This is in contrast to the bond mindset, characterized by investment banks and fund managers, who are accustomed to pricing the value of their investments daily against the market.¹⁰⁴ If a loan’s value rises or falls, they view it as an

97. See OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

98. Dutta, *Institutional Investors’ Rush to Bank Loans Poses a Puzzle for Banks*, *supra* note 95, at 12. Investors earn interest on their bond inventory but it exists primarily to make a profit on the difference between purchase and sale price. See *id.* Thus, this mind-set is characterized by investors that are accustomed to weathering the risk that the market value of its inventory might decrease. See *id.*

99. Dutta, *Institutional Investors’ Rush to Bank Loans Poses a Puzzle for Banks*, *supra* note 95, at 12 (stating that “what someone with a senior secured mind-set might view as a risk to a transaction—and a reason to bail out—someone with a bond mind-set would see as an opportunity to invest more”).

100. See Weidner, *Wall Street Taking Steps to Speed Growth of Secondary Loan Market*, *supra* note 60, at 1.

101. See *id.*

102. See *id.*

103. See *id.*

104. See *id.*

opportunity to buy or sell to balance their portfolios.¹⁰⁵ Market volatility is desirable, and thus institutional investors are more risk tolerant.

If institutional investors become a majority of the syndicated credit agreement, this position could give them the votes necessary to control the future of a deal. Many bankers are "loath" to allow these nontraditional institutional investors to take control of a lending group: "[t]he fear is that the investors will force bankers to remain committed to transactions with which they are uncomfortable."¹⁰⁶ For example, if institutional investors gain control of more than 50% of a syndicated loan, syndicate members should be concerned about the fate of the syndicate in case of default. Typically, if a borrower defaults, the result is acceleration by the syndicate members of all outstanding borrowings and immediate nullification of the syndicate's commitment to lend.¹⁰⁷ However, most standard credit agreements provide that the borrower is not in default until the agent declares to the borrower that the occurrence is an event of default.¹⁰⁸ An agent bank often may not declare default without first obtaining permission of a majority or all of the syndicate members, depending on the specific agreement.¹⁰⁹ Thus, if disputes arise among lenders, bankers versus institutional investors, concerning the correct course of action, the result may delay or thwart a lender's need to act quickly and decisively.¹¹⁰

This inability to agree and the delay it causes can result in a costly loss of rights by the lenders. For example, if lenders cannot agree whether to set off¹¹¹ balances or to exercise remedies against

105. See *id.*

106. Dutta, *Institutional Investors' Rush to Bank Loans Poses a Puzzle for Banks*, *supra* note 95, at 12.

107. See Palmer, *supra* note 42, at 885.

108. See *id.* See generally Mark Thompson, *Recent Developments Involving Distressed Bank Debt*, in BANKING AND COMMERCIAL LENDING LAW, at 427 (ALI-ABA Course of Study, 1996) (noting the growing trend of bank lenders to dispose of distressed loans rather than holding on through workout or Chapter 11).

109. See William C. Tompsett, *Interbank Relations in Loan Participation Agreements: From Structure to Workout*, 101 BANKING L.J. 31, 34 (1984). "A multibank agreement generally provides that certain action, including the acceleration of payments after default . . . may or must be taken with the consent of a certain specified percentage or number of banks." *Id.*

110. See Hirshfield, *supra* note 20, at § 10.03[5][a].

111. See generally Edwin E. Smith, *Securities Interest in Deposit Accounts*, in THE EMERGED AND EMERGING NEW UNIFORM COMMERCIAL CODE, at 129 (ALI-ABA Course of Study, 1996) (identifying a set-off in a syndicated credit as a problem area).

collateral¹¹² of a defaulting borrower, the delay could give the borrower enough time to take action that will end up costing the lenders.¹¹³ The lenders' disagreements give the borrower as a debtor in possession time to maneuver to put off or prevent a set off,¹¹⁴ enforce the stay against the lenders notifying account debtors or other proceeding against the collateral,¹¹⁵ or perhaps even obtaining the use of the lenders' collateral.¹¹⁶ The attitudes concerning investment between banks and institutional investors, and the time it takes to resolve them, can result in financial loss. Thus, because of the influx of institutional money into the bank loan market, banks now are facing the problem of staying in control of the transactions they become a part of.

In addition, institutional investors could influence the market so that commercial banks could not participate without investment in trading expertise.¹¹⁷ This second effect of the influx of institutional money may cause a paradigm shift in how loans are valued. Institutional investors' trading mentality could change the market for syndicated loans drastically. As loans on the secondary market become more liquid, trades will become more frequent and prices will become more accurate. This will make it easier to judge the value of a loan as determined by the market (which institutional investors desire),¹¹⁸ not its face value (which bankers are accustomed to using). Smaller banks, which do little or no secondary trading, might suffer the most.¹¹⁹ This is because larger banks, more adept at secondary trading, would be able to sell more loans to investors without holding significant portions.¹²⁰ Large banks will then originate syndicated

112. *See id.* An example of this would be notifying the debtors to pay their outstanding accounts receivable directly to the lenders before the filing of a reorganization petition. *See id.*

113. *See id.*

114. *See* 11 U.S.C. § 362 (1994).

115. *See id.*

116. *See id.* § 363.

117. *See* Weidner, *Wall Street Taking Steps to Speed Growth of Secondary Loan Market*, *supra* note 60, at 1.

118. *See id.* (quoting a director from Standard and Poor's about how a shift to daily pricing would mark a fundamental change for commercial banks: "It was never part of a banker's model for thinking about those kinds of market conditions. A banker never cared if he could sell those loans for 100 cents on the dollar.").

119. *See id.*

120. *See id.*

loans for volume, driving down returns for smaller banks.¹²¹ To make up for loss of market share consumed by the large banks that would be striving for quantity of loans, small banks would need to become active players in the secondary market, which would require a costly investment in a sophisticated trading desk.¹²² Thus, as more institutional investors enter the syndicated loan market, and the trading mentality becomes more the rule than the exception, commercial banks unwilling to embrace the trading mentality may be driven out of the market.

2. Increased Competition

Another more subtle structural risk faced by banks of increased involvement of institutional investors is increased competition for financial services.¹²³ The syndicate members each have a direct relationship with the borrower.¹²⁴ An agent, or any member of a syndicate, that had an exclusive relationship or even a preferred relationship with the borrower before the syndicated credit might find it difficult to maintain.¹²⁵ Syndicate members ultimately may have to compete among themselves for desirable business from the borrower.¹²⁶ Thus, the agent may be personally introducing the competition to its customers.¹²⁷ By including institutional investors in syndicated transactions, banks are running the risk of graduating their own clients into these other firms.¹²⁸ As unregulated non-banks begin to offer more diverse financial services,¹²⁹ this impact of this risk has

121. *See id.* (A volume business focuses on fee income rather than loan income. *See id.* A secondary market would eliminate pricing efficiencies, and drive down spreads on new loans. *See id.*

122. *See id.*

123. *See* Palmer, *supra* note 42, at 885. *See also* OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

124. *See id.*

125. *See* Hirshfield, *supra* note 20, § 10.03[5][a].

126. *See id.*

127. *See id.*

128. *See id.*

129. *See id.* For example, General Electric is planning to enter the syndicated loan market in 1999. *See* David Weidner, *GE Capital Service Aims to Compete as Loan Syndication Leader*, AM. BANKER, Dec. 15, 1998, at 29. The \$250 billion asset unit of GE has participated in the syndicated credit market for some time by buying deals structured by other banks. *See id.* Now, however, it wants to compete to lead large loans

potentially far-reaching consequences for bank' maintenance of market share.¹³⁰

Banks can overcome the problems created by institutional investment with the right management. First, a bank's risk management structure should anticipate future economic problems. The syndicated credit transactions that banks underwrite should be "consistent with its long-term strategic portfolio objectives and the level of risk the bank is willing to tolerate over the long run."¹³¹ Thus, when considering syndicated lending, a bank must weigh the inevitable influx of institutional investors and the concomitant challenges, increased competition and loss of control of the syndicate. Also, banks should structure "compensation systems for the lending area (which would) reward the kind of behavior that is consistent with long-term credit quality objectives."¹³² Second, a bank's credit culture¹³³ should "reflect the standards and values of the board of directors and senior management."¹³⁴ Thus, lenders should be wary of purchasing loans that are based on underwriting standards set by another syndicate member that are significantly different from their own internal criteria.¹³⁵ To assure compliance with the bank's credit culture, the OCC recommends that a bank's senior management and the board "should periodically assess whether employees' understanding of the bank's credit culture, and their resulting behavior, conform with the desired standards and values for the bank."¹³⁶ Additionally, independent audit and internal loan review functions could help in this assessment.¹³⁷

for companies in sectors in which it has expertise. *See id.*

130. *See id.* When asked if commercial banking could eclipse investment banking, one businessman tellingly replied that "Investment bankers think more like businessmen. . . . Some of the commercial banks are trying to change, but they don't have the reputation yet. Unless they're bringing a product that is unique to them, they really *don't have a lot more to offer* than an investment bank does." Omri Ben-Amos, *Wanted: A Relationship Beyond the Deal*, AM. BANKER, Mar. 17, 1997, at 24 (emphasis added).

131. OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

132. *Id.*

133. *See id.*

134. *Id.*

135. *See id.*

136. *Id.*

137. *See id.* The OCC has acknowledged "the need to formalize the various elements" will "depend on the size of the bank, the complexity of its portfolio, and the credit risks it has assumed." *Id.*

B. *Easing of Credit Terms*

Additionally, the great influx of new entrants in the syndicated credit loan market has increased competitive conditions which have "encouraged an easing of credit terms and conditions in both commercial and consumer lending."¹³⁸ A prospering economy has shored up weak credit terms, allowing banks to survive the weaknesses in their loan agreements while the economy is good. One example of this is the lack of covenants in the syndicated credit agreements.¹³⁹ Most banks make a decision to extend credit to a borrower based on the borrower's credit rating and business prospects.¹⁴⁰ Thus, throughout the term of the loan, a prudent bank will want to enact certain restrictions on the borrower's business to maintain the continued good health (repayment ability) of the borrower.¹⁴¹ These restrictions are designed to ensure that a borrower maintains a sufficient operating cash flow to amortize any borrowings, a credit status that stays at a level which banks feel is commensurate with the loan commitment, and sufficient assets to remain a viable entity throughout the entire term of the loan.¹⁴² These goals are achieved through contractual covenants.¹⁴³ Therefore, the absence of this credit term in syndicated credit agreements leaves the very repayment ability of the borrower undermined, exposing the syndicate

138. *Id.* Likewise, the Federal Reserve Board stated that "the recent easing may not be imprudent, the incentives and pressures to lower credit standards have increased as competition has intensified and borrowers have experienced generally favorable business and economic conditions." FRB Supervision and Regulation Letter 97-21, *Secondary Market Credit Activities*, [Vol. 4 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 37,707, at 37, 710 (July 11, 1997).

139. See Omri Ben-Amos, *Honeywell Demands that its Banks Understand It*, AM. BANKER, June 11, 1997, at 19. Honeywell's recently acquired \$1.325 billion, five year revolver syndicated credit agreement contained no financial covenants. See *id.* When asked if banks resisted the absence of covenants, the chief financial officer replied that he "encountered some resistance, but we were able to overcome that by focusing on the total financial relationship that we wanted and expected to have with our banks." *Id.*

140. See Palmer, *supra* note 42, at 865.

141. See *id.* See also Dev Strischek, *Coming to Terms with Financial Covenants*, 76 J. OF COMM. LENDING 11 (1994); Julie A. Whitaker, *Guidelines for Structuring Loans*, 75 J. OF COMM. LENDING 18 (1993) (discussing "negotiating tips" from the bank's perspective).

142. See Palmer, *supra* note 41, at 868.

143. See *id.* at 868-79 (listing typical provisions in covenants). These covenants can be affirmative, requiring the borrower to act, or negative, prohibiting the borrower from acting or allowing specified events to occur. See *id.*

members to possible financial loss.¹⁴⁴

Syndicate members should also plan for changes in tax increases, new laws, new regulatory capital rules, or new reserve requirements that may arise after the syndicated credit agreement is entered into by including a protective credit term.¹⁴⁵ Prospective thinking concerning the administrative segment in a portfolio can help syndicates establish predetermined courses of action.¹⁴⁶ Thus, syndicates can avoid the unpleasantness of having to negotiate a new term in a time of crisis, and after the original deal has been completed, which drastically reduces the syndicates' bargaining power. To insure a certain profit from the transaction, an agent should put in the loan agreement a credit term that borrowers absorb these additional costs.¹⁴⁷

Active loan portfolio management can avert some of the risks presented by loose credit terms, allowing banks to remain competitive while protecting against risk. Active loan portfolio management views management in terms of the entire portfolio, as opposed to a more traditional approach of individual loan oversight, in managing overall credit risk.¹⁴⁸ The OCC views it as an essential tool in trouble-shooting for prospective financial.¹⁴⁹ A primary goal of active loan portfolio management is to control the strategic risk associated with lending.¹⁵⁰ Poor strategic decisions about "underwriting standards, loan portfolio growth, new loan products, or geographic and demographic markets" can jeopardize a bank's future.¹⁵¹ Active loan

144. *See id.* *See also Chase Amends Bruno's*, 12 BANK LOAN REP. 37, Sept. 15, 1997, available in 1997 WL 11236726 (discussing that as agent of Bruno's Inc.'s syndicated credit agreement, Chase Manhattan agreed to an amendment and waiver of certain financial covenants which will permit Bruno's to use up to \$200 million under the revolving credit portion of its bank credit facility, despite declining sales).

145. *See Palmer, supra* note 42, at 888.

146. *See* OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

147. *See id.*

148. *See id.* "An effective loan portfolio credit risk management process enables management to identify, measure, monitor and control credit risk." *Id.*

149. *See* Omri Ben-Amos, *CIBC Unit Hire Loan Portfolio Chief*, AM. BANKER, Sept. 2, 1997, at 13. The trend of active portfolio management can be seen in the marketplace. *See id.* The role of loan portfolio managers will become more important as the bank loan market expands and syndicated loans become increasingly liquid. *See id.*

150. *See* Office of the Comptroller of the Currency, *Risks Associated with Lending: Loan Portfolio Management*, COMPTROLLER'S HANDBOOK (April 1998), available in 1998 WL 161400 [hereinafter *Loan Portfolio Management*].

151. *Id.* The OCC warns that examiners should be particularly alert to new business

portfolio management can help minimize the risk of inadequate credit terms that banks undertake when participating in a syndicated loan. It is broken down into three phases: planning, acquisition, and monitoring and review.¹⁵²

The first phase is portfolio planning.¹⁵³ Instead of making decisions on a transaction by transaction basis, loan decisions would be made in accordance with a bank's ideal portfolio.¹⁵⁴ Using a planning effort involving the line business units, senior management, and board of directors, a bank would determine its ideal portfolio.¹⁵⁵ It would establish the markets it wishes to target, volume and types of credit it is willing to offer, and prices it will charge up front.¹⁵⁶ The ideal portfolio would be the "measuring stick" that all other potential transactions would be evaluated against prior to making any lending decisions and credit terms would have to comport with it.¹⁵⁷ A bank's lender and marketing personnel, armed with this information, could look for credits that meet the established criteria. More importantly, the established criteria can reign in lending and generous credit terms during a positive economic environment.¹⁵⁸

The second phase in portfolio management is portfolio acquisition.¹⁵⁹ In this phase, the bank will use some tools, such as

and product ventures that require significant planning and oversight to ensure adequate risk management. *See id.* For example, many banks loan to "sub-prime" borrowers. *See id.* The lending activity may be familiar, but the borrower's behavior may vary drastically from a bank's average customer. *See id.* *See also* Evan Gilreath, Note, *The Entrance of Banks into Subprime Lending: First Union and The Money Store*, 3 N.C. BANKING INST. 149 (1999) (discussing the current trend of banks acquiring subprime lending institutions).

152. *See* Loan Portfolio Management, *supra* note 150.

153. *See* Carol M. Beaumier, *Active Credit Portfolio Management May Avert Serious Loan Problems*, BANKING POL'Y REP., Dec. 1, 1997, at 1, available in LEXIS, Bankng Library, Bnkppl File.

154. *See id.*

155. *See id.*

156. *See id.* In particular cases, banks could identify target clients by name, and in effect, those will be pre-underwritten. *See id.*

157. *See id.* at 15. Where transactions that meet the established bank criteria cannot be found, bankers are using credit derivatives to redesign their portfolios. *See id.* These can be used to "lay off concentration risk, to reduce individual borrower risk, or even add a certain type of risk, i.e., an industry risk, that may be a buffer to protect other loans in the portfolio." *Id.* at 16.

158. *See id.* Thus, a bank can increase the efficiency and effectiveness of marketing efforts and target specific risk levels by gathering portfolio information. *See id.*

159. *See id.* (defining portfolio acquisition as "how the institution analyzes, structures, documents, approves, and books individual transactions").

facility and obligor grades, quantitative models, pricing models, and industry and geographic analysis, which assist in the underwriting process and provide data that is critical to the ongoing management of the portfolio.¹⁶⁰ It identifies areas that are vital to the bank's survival, allowing bank staff to draft credit terms with this in mind.¹⁶¹ The more detailed analysis, the better information it provides upon which banks can base their decisions.¹⁶² The portfolio acquisition stage, with its attention to detailed analysis, allows bankers and examiners to see the first hint of storm clouds indicating that a portfolio plan is being undermined. This occurs when exceptions to policy and credit term standards stop becoming the exception and start becoming the norm. In a time of economic health, the number and nature of exceptions may be a banker's only way to detect portfolio deterioration.

The final phase of portfolio management is monitoring and review, where a bank compares its existing portfolio with the portfolio it intends to acquire. When the actual portfolio differs from the planned portfolio, a bank should investigate the cause(s) of the variance.¹⁶³ Any variances from the bank's established policy, whether in the actual lending or just the credit terms of a loan agreement, that could have a material impact on the bank should be brought to the attention of the bank's senior management and board.¹⁶⁴

Further, the OCC advises that banks should have systems in place to analyze and control exceptions to their lending policies.¹⁶⁵ These systems should be implemented in this final stage of the loan

160. *See id.*

161. *See id.*

162. *See id.*

For example, a bank that uses a 10-point grading system and the analysis that can be derived from it is far more informative than a grading system that uses more vague categories of pass, special mention, substandard, doubtful, and loss. And, industry analysis that attempts to correlate the performance of different industry segments is much more useful than a standard industrial classification (SIC) listing.

Id.

163. *See id.* This analysis requires segmenting the portfolio in many ways (loan type, borrower, collateral, geography, risk grade, rate, currency, and responsible office/officer). *See id.*

164. *See id.* If the second phase of the active loan portfolio management is not done well (and not enough data is gathered), then the third phase will not be as accurate. *See id.* If it is done well, however, trends and patterns that, taken alone would indicate nothing, could evidence a troubling variance in phase three. *See id.*

165. *See* Loan Portfolio Management, *supra* note 150.

portfolio analysis. The OCC advises banks to track the aggregate level of exceptions in order to detect shifts in the risk characteristics of the loan portfolios.¹⁶⁶ Further, the OCC recommends that bank management should “consider developing ‘what if’ scenarios¹⁶⁷ for key portfolio segments.”¹⁶⁸ These scenarios would identify “possible credit risk triggers or event that could increase risk for a portfolio segment or for the portfolio as a whole.”¹⁶⁹ Such scenarios would help syndicate members avoid the unseen detriments of changed circumstances.

Thus, a what-if scenario that focused on the interest rate segment would necessarily include a plan for what would happen if the interest rates that the syndicated credit is based on become inadequate to fully compensate the syndicates.¹⁷⁰ Since each bank’s cost of funds is different,¹⁷¹ each syndicate must independently establish its own tolerance thresholds. This forward-looking recommendation stimulates the agent to put in the credit agreement (before any sign of risk) a credit term which would suspend the obligation of the banks to make the type of loan affected until conditions change if interest rates become inadequate.¹⁷² Further, if an agent determines that it is not possible to continue to maintain the existing loans at the changed rate, then it could also include a credit term that allows the repayment of these loans or their conversion into a loan based upon another interest rate.¹⁷³ This federal recommendation helps agents and syndicates avoid the grave financial consequence of having to maintain a syndicated loan that costs the bank to maintain.

Careful drafting of credit terms also help guard against more subtle risks.¹⁷⁴ This is because the risks involved in syndicated loans, while not new to banking, “may be less obvious and more complex

166. *See id.*

167. *See* OCC Advisory Letter 97-3, *supra* note 94, at 73,273. These scenarios “may include interest rate changes, commodity or other price shocks, economic cycles, or technological, political, or sociological changes.” *Id.*

168. *Id.*

169. *Id.*

170. *See* Palmer, *supra* note 42, at 887.

171. *See id.* This cost depends on factors such as: regional location, business climate, and credit status. *See id.* at 888.

172. *See id.*

173. *See id.*

174. *See* FRB Supervision and Regulation Letter 97-21, *supra* note 138, at 37,707.

than the risks of traditional lending activities.”¹⁷⁵ Bank managers were warned by the Federal Reserve Board that this syndicated credit activity could “involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated in an institution’s risk management systems.”¹⁷⁶ It further noted that “certain credit and liquidity enhancements¹⁷⁷ that banking organizations provide to facilitate various secondary market credit activities may make the evaluation of the risks of these activities less straightforward than the risks involved in traditional banking activities in which assets are held in their entirety on the balance sheet of the originating institution.”¹⁷⁸

Thus, if the inclusion a credit term moves the credit risk “associated with traditional on-balance-sheet assets into off-balance-sheet contingent liabilities,”¹⁷⁹ the actual credit risk can be difficult for inexperienced lenders to assess.¹⁸⁰ As borrowers shift credit risk off the balance sheet, the risk implications of such a credit term need to be thoroughly understood before an unsuspecting lender makes any commitments.¹⁸¹ For example, a risk that is not represented on a balance sheet occurs when there is an unexpected change in circumstances that the syndicated credit agreement did not address, such as when the “basis for determining interest rates becomes

175. *Id.* Former Comptroller Ludwig has stated that risks are particularly great “for downstream participants—banks that buy up pieces of large loans from other, typically bigger, lenders.” Domis, *supra* note 1, at 1.

176. FRB Supervision and Regulation Letter 97-21, *supra* note 138, at 37,707.

177. *See id.* “These enhancements . . . usually manifest themselves as recourse provisions, securitization structures that entail credit-linked early amortization, and collateral replacement events, and direct credit substitutes such as letters of credit . . .” *Id.* *See also* FRB Supervision and Regulation Letter 96-30, *Risk Based Capital Treatment for Spread Accounts that Provide Credit Enhancements for Securitized Receivables*, [Vol. 4 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 51,906, at 51,908 (Nov. 7, 1996) [hereinafter FRB Supervision and Regulation Letter 96-30].

178. FRB Supervision and Regulation Letter 97-21, *supra* note 138, at 37,707-11.

179. *Id.* at 37,707-11. The Federal Reserve highlights several transactions that may potentially expose a bank to risk even if they are removed from the balance sheet: “loan sales with recourse, credit derivatives, direct credit substitutes, such as letters of credit, and liquidity facilities extended to securitization programs. . . .” *Id.*

180. *Id.* This is particularly true as the complexity and indirect nature of these transactions increase. *See id.*

181. *See* OCC Advisory Letter 97-3, *supra* note 94, at 73,272-73.

unavailable or provides inadequate compensation to the banks.”¹⁸² Even if there are credit terms within the loan agreement that provide for the method of obtaining an applicable interest rate, a situation may arise where no market in dollar deposits for the interest period desired by the borrower is available.¹⁸³ Another example of a changed circumstance is when new regulatory requirements are subsequently adopted by banking regulators that apply to the agreement and that increase the cost to the banks of maintaining a particular loan.¹⁸⁴ These risks, if not properly addressed by carefully drafted credit terms, are effectively shifted from borrowers to banks because banks must ultimately absorb the cost. Thus, without careful consideration of credit terms, syndicate banks unknowingly may be exposing themselves to hidden obligations that may not become evident unless and until the transactions deteriorate.

C. *Internal Controls*

A third risk presented by syndicated credits is that a bank does not have the infrastructure necessary to compete successfully in the syndicated loan market.¹⁸⁵ New entrants are rapidly entering the syndicated loan market.¹⁸⁶ Those that wish to be successful cannot underestimate the necessity of having adequate internal mechanisms to thrive in the syndicated market.¹⁸⁷ Clearly, as competition increases, industry recognition and reputation will be vital for an agent's continued survival in the syndicated loan market.¹⁸⁸ Adequate internal

182. Palmer, *supra* note 42, at 887.

183. *See id.*

184. *See* FRB Supervision and Regulation Letter 97-21, *supra* note 138, at 37,707-10 (stating that banks “should remain alert to the possibility that loan performance could deteriorate if certain sectors of the economy experience problems”).

185. *See* Mahua Dutta, *Syndicated Loan Boom May Hurt Due Diligence*, AM. BANKER, July 24, 1997, at 8.

186. *See* Omri Ben-Amos, *Credit Risk Management Trend: Policing Whole Loan Portfolios*, AM. BANKER, Sept. 19, 1997, at 7. Preliminary findings of a new risk management survey among 64 banks with assets of more than \$5 billion showed that while only 24% of banks now use syndications to manage their corporate loan portfolios, 57% of those surveyed expect to use them often by 1999. *See id.* Robert Morris Associates conducted the survey, while a consultant at First Manhattan Consulting Group analyzed it. *See id.*

187. *See* OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

188. *See* Loan Portfolio Management, *supra* note 150.

infrastructure can help banks gain that recognition and reputation.¹⁸⁹ Typically, weak internal controls are marked by two deficiencies: inadequate staffing and inadequate management information systems.

1. Inadequate Staffing

Despite the syndicated loan market's rapid increase,¹⁹⁰ bank loan staffs have not been expanding at the same level.¹⁹¹ Bank loan departments have not regained the manpower they had in the early 1990s, before they fell victim to the vigorous cost-cutting programs.¹⁹² In this increasingly competitive marketplace, the main question syndicate members ask is, "How on top of the credit is the agent?"¹⁹³ This question marks a valid concern of the sufficiency of a bank's due diligence about borrowers.¹⁹⁴ The objective of due diligence is typically to "ascertain *and* corroborate all material facts concerning a specific transaction."¹⁹⁵ Thus, an agent should gather and corroborate all material facts about a borrower.¹⁹⁶ Regulators have also noted that due diligence is suffering as banks compete for deals based on speed.¹⁹⁷ Given these circumstances, syndicate members are taking on the discipline themselves while dealing with what they view as a slide in the discipline of the agent banks.¹⁹⁸ Due diligence cannot be done quickly (to keep up with demand of market) without adequate staffing levels.¹⁹⁹ However, there is a recognizable reward for national banks that make this investment in staff: increased reputation, the ability to

189. *See id.*

190. *See* Dutta, *Syndicated Loan Boom May Hurt Due Diligence*, *supra* note 185, at 8.

191. *See* OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

192. Dutta, *Syndicated Loan Boom May Hurt Due Diligence*, *supra* note 185, at 8.

193. *Id.*

194. *See id.*

195. *See* Scott M. Zimmerman & Daniel I. Goldberg, *Due Diligence and Its Impact on the Transaction*, in *ADVANCED DOING DEALS: A STRATEGIC APPROACH TO COMPLETING TRANSACTIONS* 245 (1998) (emphasis added).

196. *See id.*

197. *See* Dutta, *Syndicated Loan Boom May Hurt Due Diligence*, *supra* note 185, at 8 (noting that regulators noticed banks' willingness to compromise due diligence).

198. *See id.* Some syndicate members have reported that they "have received from agent-banks incomplete information on deals." *Id.* Some said they even have been asked "to commit to loans without being shown any documentation." *Id.*

199. *Id.* (observing that lenders at one particular bank are given only two weeks to complete due diligence on some borrowers, with those lenders "juggling and hoping that everything turns out all right").

get and process financial information quickly, and the possible gain of market share in ever-crowded marketplace.²⁰⁰ Thus, without an adequate staff to complete due diligence thoroughly and quickly, an agent bank may not succeed in the crowding syndicate loan marketplace.

There is much to gain when a bank performs due diligence well, thereby improving its reputation among investors.²⁰¹ Banks that wish to become agents in syndicated transactions must maintain the ability to attract a cadre of other lenders.²⁰² Further, every client relationship that a bank can cultivate increases its chances for being chosen as agent and entitled to earn lucrative fee income.²⁰³ An adequately sized staff that allows due diligence done quickly and accurately can help banks do this.

Adequate staff levels can also help banks avoid risks.²⁰⁴ Loan syndication underwriting may present significant risk exposure to lead underwriters because "syndicate participants may seek to hold the lead underwriter responsible for actual or perceived inadequacies in the loan's underwriting even though the participants are responsible for conducting an independent due diligence of the credit."²⁰⁵ There may be pressure on the agent-bank to "repurchase portions of the syndication if the credit deteriorates in order to protect its reputation in the market even though the syndication was sold without recourse."²⁰⁶ A staff's timely performance of adequate due diligence would greatly reduce this possibility.

The need for due diligence increases greatly when an agent is

200. See Loan Portfolio Management, *supra* note 150. See also OCC Advisory Letter 97-3, *supra* note 94, at 73,271

201. See Ben-Amos, *Honeywell Demands that its Banks Understand It*, *supra* note 139, at 6. Chase Manhattan Bank was chosen to lead a \$1.325 billion five-year syndicated credit agreement for Honeywell, Inc. See *id.* The Chief Executive Officer of Honeywell remarked that Chase "has earned this business, based upon their relationship, their service, and their leadership in the syndicated credit market." *Id.*

202. See *supra* note 35 and accompanying text. Agent banks are chosen to lead the syndicate based on, among other things, their ability to attract lenders. See *supra* note 35 and accompanying text.

203. See *supra* note 35 and accompanying text.

204. See Loan Portfolio Management, *supra* note 150. Damage to a bank's reputation can cause the value of a bank's stock to fall, a loss of customer and community support, and a loss of new business opportunities. See *id.*

205. FRB Supervision and Regulation Letter 97-21, *supra* note 138, at 37,707-13.

206. *Id.*

entering a credit agreement with a borrower that is part of an industry that the agent is unfamiliar with.²⁰⁷ For example, normal practice in the jewelry industry is that when a sale occurs between jewelers, payment is not required until there is a sale to an ultimate customer.²⁰⁸ This is not a written industry standard, but rather an accepted custom.²⁰⁹ One bank, which did not investigate the jewelry industry, extended two lines of credit totaling over \$1 million to a jewelry wholesaler.²¹⁰ Because the repayment by the wholesaler was contingent on the resale of the underlying goods by the retailer, the bank was exposed to risk from an aging of the trade note should the loan not pay at maturity.²¹¹ Further, the bank was exposed to any intervening deterioration in the borrower's financial condition or the possibility of loss or diversion of the underlying goods.²¹² The bank ultimately sustained significant losses because it did not perform due diligence about the company's practices, thus, not properly structuring the loan. Therefore, due diligence can insulate banks from taking risks that can be avoided prior to the issuance of the loan.

One of the world's five largest biotech firms secured a \$225 million syndicated loan in December 1996.²¹³ The experience of its chief financial officer in that deal is illustrative of how the inadequate nature of an agent's due diligence can affect an agent-bank's reputation.²¹⁴ His complaint was that "*by the time* they found more about us through their due diligence, they decided we were riskier than they wanted a client to be."²¹⁵ This just an example of the larger trend: that the quality and thoroughness of due diligence conducted by agents of borrowers is slipping, causing potential problems for the banks and other institutions that buy pieces of syndicated loans.²¹⁶ The

207. ROBERT MORRIS ASSOCIATES, *SPILLED MILK: A SPECIAL COLLECTION FROM THE JOURNAL OF COMMERCIAL BANK LENDING ON LOANS THAT WENT SOUR* 13 (1985).

208. *See id.* at 14.

209. *See id.*

210. *See id.* at 13.

211. *See id.* at 14.

212. *See id.*

213. *See Ben-Amos, Wanted: A Relationship Beyond the Deal, supra* note 130, at 24.

214. *See id.* David J. McLachlan, chief financial officer, stated that "[w]e went almost to the altar with another bank, and *at the last minute* . . . they backed out and left us high and dry." *Id.* (emphasis added).

215. *Id.* (emphasis added)

216. *See Dutta, Syndicated Loan Boom May Hurt Due Diligence, supra* note 185, at 8.

due diligence problem is attributed to the agents "who increasingly are promising to get money to their clients fast."²¹⁷

The OCC deemed due diligence important enough to proscribe specific aspects of it to reduce credit risk.²¹⁸ It advises that a bank "should segment its portfolio in a number of different ways."²¹⁹ Banks should identify risks to identify possible covariances, similarities, or interrelationships among portfolio segments.²²⁰ Thus, only after risk diversification objectives have been established by the staff, via due diligence analysis, is a bank able to ascertain what terms should effect their lending decisions.²²¹ This type of thoroughness that will insure a bank's continued survival in the syndicated loan marketplace.

2. Inadequate Management Information Systems

The OCC has observed that the syndicated credit management information systems (MIS) has not kept pace with loan portfolio growth.²²² Today's loan portfolio managers must base their decisions on "moving pictures across a broad spectrum of market, operational, and credit risks."²²³ Banks with inadequate MIS are making decisions without the detailed information that is essential to this analysis.²²⁴

217. *Id.* (resulting in banks trying to make more deals in less time).

218. See OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

219. See *id.* Examples include loan type, industry, geography, structure, collateral, tenor, and risk of default or loss. See *id.* at 73,272. "The same loan may be included in several portfolio segments based on different risk elements." See *id.*

220. *Id.* For further reasons why banks should segment its portfolio, see James H. Gilkeson & Gary E. Porter, *Large Retail Time Deposits and U.S. Treasury Securities (1986-95): Evidence of a Segmenting Market*, Office of the Comptroller of the Currency, E&PA Working Paper 97-12, July 1997, <www.occ.treas.gov/wp97-12.htm>. "Flight from insured balances into money market funds and other uninsured investments has left banks with a group of investors who are uncommonly insensitive to interest rates, or equivalently, have the highest switching costs." *Id.* A bank that has not segmented its portfolio would not be able to take advantage of the OCC paper's ultimate conclusion that banks "are able to extract available surplus from the depositor segment of the risk-free debt investors." *Id.* This surplus "helps to make up for the loss of the banks' more rate-sensitive investors." *Id.*

221. See OCC Advisory Letter 97-3, *supra* note 94, at 73,271.

222. *Id.*

223. See Patricia A. Murphy, *Enterprisewide Risk Targeted by Managers*, AM. BANKER, Aug. 5, 1996, at 12A.

224. See *id.* The OCC recommends that the senior management and board members assess periodically the adequacy of their bank's credit MIS "in light of recent loan growth,

Due to the size of a loan portfolio, effective management of it requires good information on aspects of a bank's lending unit.²²⁵ An adequate MIS provides this good information by giving "banks the ability to segment their loan portfolios and to assess more accurately key risk characteristics."²²⁶ Thus, one way for banks to reduce the risk of syndicated lending is to invest in an adequate MIS.

Ways that an adequate MIS can provide effective management for banks is illustrated by examining its application to liquidity risk, a common risk associated with lending about a bank's ability of convert obligations into money if necessary.²²⁷ With the right information, banks can use their loan portfolio as a source of liquidity by "reducing the total dollar volume of loans through sales, securitization, and portfolio run-off."²²⁸ An adequate MIS can provide information that will help a bank decide which of its existing loans it should liquidate. It can do this by identifying those loans or loan portfolio segments that are easily convertible into money.²²⁹ A MIS can keep track of a loan's "quality, pricing, scheduled maturities, and conformity to market standards for underwriting," all of which will help a bank determine a loan's liquidity.²³⁰ A loan's marketability depends on the type and quality of the loan.²³¹ A MIS can provide this information on each individual loan for an entire loan unit. Thus, a MIS can provide banks

acquisitions, and changes in the bank's appetite for risk." OCC Advisory Letter 97-3, *supra* note 94, at 73,271 (emphasis added).

225. See Loan Portfolio Management, *supra* note 150. Traditionally, the loan portfolio has not been viewed as a significant source of funds for liquidity management. See *id.* But, with the advent of a secondary market for loans, this may change. See *supra* notes 60-65 and accompanying text.

226. See OCC Advisory Letter 97-3 *supra* note 94, at 73,271. Also, the OCC has made clear that it will evaluate "whether senior management has sufficient knowledge and skills to manage the bank's use of technology." *Id.* To that effect, former Comptroller Ludwig stated that "it is vital that the bank's senior management—right up to the chief executive officer—understand the risks and opportunities presented by technology." *Id.*

227. A liquidity risk is one of nine categories that the OCC has identified as a risk incident to lending. See Loan Portfolio Management, *supra* note 150.

228. See *id.* Loans are also a source of liquidity when used as collateral for borrowings. See *id.* However, a bank that decides to reduce or sell existing commitments must consider reputation risk and the potential for lender-liability actions. See *id.* A bank's ability to maintain a customer base will be reduced if it is viewed as an unreliable lender. See *id.* Further, its reputation may suffer if the community perceives it as unwilling to support community credit needs. See *id.*

229. See *id.*

230. *Id.*

231. See *id.*

with valuable information which help them make lucrative decisions.

Liquidity is also influenced by the amount of a bank's commitment to lend and the actual amount that a borrower has drawn against that commitment.²³² A MIS could provide a system to track such commitments and borrower usage.²³³ It could also provide up-to-date information on the types of commitments, prospective deals, and average usage levels to help banks predict how much liquidity will be needed in the future.²³⁴ Further, it could distinguish between commitments that a bank is legally obligated to fund and those that it is not helping banks determine which commitments are discretionary and can be legally liquidated from a bank's books.²³⁵ Therefore, a MIS can help banks predict their future liquidity requirements and fully comply with their legal obligations.

Lastly, besides being an aide to making salient business decisions, a MIS can be used for product development.²³⁶ The latest computer systems can be used to make money, not just as a defensive mechanism or an analysis tool.²³⁷ While normally a bank's balance sheet may create risks connected to a sudden downturn in interest rates, it's possible to use an MIS to create financial products that have the opposite effect.²³⁸ Thus, modern MIS can solve both existing and future problems.

IV. CONCLUSION

Banks need to address the risks associated with syndicated credits. Investment in solutions to these risks will not only reduce a bank's risk level, but also increase a bank's ability to attract and retain customers. Further, such voluntary action will likely reduce the attention paid to syndicated loans by federal regulators.²³⁹ If banks

232. *See id.*

233. *See id.*

234. *See id.* High usage levels would help determine if the available liquidity will be adequate. *See id.*

235. *See id.*

236. *See* Murphy, *supra* note 223, at 12A.

237. *See id.*

238. *See id.*

239. The OCC's regulations are "risk-focused and results-oriented." OCC Bulletin 97-8, *OCC Standards for Developing Regulations Description*, [Vol. 4 Transfer Binder] Fed. Banking L. Rep. (CCH), ¶ 35,103 (Jan. 21, 1997). By reducing the risks

want to avoid regulation and its accompanying costs,²⁴⁰ they should take steps to deal with the risks identified in Part II. Nineteen-ninety-eight proved that economic conditions affect the volume of syndicated loans. While most banks successfully weathered the slight economic downturn, national banks would be wise to begin examining the risk of syndicated credits now instead of waiting for one celebrated disaster that reins everyone in.

MEGAN ELIZABETH JONES

voluntarily, banks can avoid the necessity of federal intervention or regulation. *See id.* Thus, if banks do not plan for the unexpected "rainy day," they can expect regulators to step in. *See id.*

240. *See id.* The OCC recognizes the potential impact of its regulation and notes in one of its organizing principles that "[r]egulations can also affect national banks' ability to compete by contributing significantly to their costs." *Id.* *See also* John P. Danforth, *Who Pays for the High Cost of Excessive Regulation?*, BANKING POL'Y REP., May 3-17, 1993, at 24, available in LEXIS, Bankng Library, Bnkppl File.

